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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 132

LOUIS H. LEWIS AND ANNETTE LEWIS AND ESTATE OF HYMAN FURST, DECEASED, BY LOUIS H. LEWIS, EXECUTOR, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. 1a–32a; R. 152–187) is not officially reported. The opinion of the court of appeals (Pet. 33a–45a) is reported at 328 F. 2d 634.

JURISDICTION

The judgment of the court of appeals was entered on March 2, 1964. (Pet. 46a.) The petition for a writ of certiorari was filed on June 1, 1964. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTIONS PRESENTED

1. Whether the taxpayers' out-of-pocket expenses incurred in connection with alleged purchases of Government securities are deductible, either in full or as long-term capital losses.

2. Whether transactions involving the alleged short sale and purchase of Government securities gave rise to deductible expenses for borrowing securities to maintain a short position.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 165. LOSSES.

(a) *General Rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

(c) *Limitation on Losses of Individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—

* * * * *

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; * * *

* * * * *

SEC. 1234 [as amended by Sec. 53, Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606]. OPTIONS TO BUY OR SELL.

(a) *Treatment of Gain or Loss.*—Gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, a privilege or option to buy or sell property shall be

considered gain or loss from the sale or exchange of property which has the same character as the property to which the option or privilege relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him).

(b) *Special Rule for Loss Attributable to Failure to Exercise Option.*—For purposes of subsection (a), if loss is attributable to failure to exercise a privilege or option, the privilege or option shall be deemed to have been sold or exchanged on the day it expired.

* * * * *

STATEMENT

This case involves two specific variants of the plans devised by M. Eli Livingstone, a Boston broker. Generally the Livingstone plans have been arrangements for reducing income taxes through the device of claiming deductions for alleged payments of interest on loans to finance the purchase of Government securities. Several of the plans have been the subject of tax litigation in the federal courts. (Pet. 35a.) Although the present case involves three taxpayers who engaged in similar transactions, the facts are summarized below, as in the court of appeals opinion, in terms of the transaction of the taxpayer Louis H. Lewis.

In the transaction of November 22, 1955 (explained in detail in the opinion below), Lewis purportedly purchased through Livingstone $1,000,000 face value of United States Treasury 2⅞% notes due March 15, 1956, at 97½, paying for them by his note for $975,000

to Corporate Finance & Loan Corporation (CF&L).[1] Livingstone placed a buy order with another dealer designated for Lewis' account, directing delivery to a New York bank against payment. At the same time he placed an order to sell identical notes for the account of CF&L. The Treasury notes never left the office of the dealer, and neither Lewis, Livingstone, nor CF&L ever acquired actual physical possession of them. The next year, on September 5, 1956, the transaction was closed out, with Lewis purporting to sell and Livingstone purporting to buy the Treasury notes, and with Lewis' purported loan marked paid. In this transaction Lewis paid $40,218.75, allegedly as pre-paid interest on his loan, but received $32,500 from Livingstone as security for an option or "put" to require Livingstone to buy the securities back on September 15, 1956, at 100¾, for a net out-of-pocket cost of $7,718.75. (Pet. 6a–18a, 33a–37a; R. 141–146, 160–165.)

Similar transactions were entered into by the other taxpayers, and a second series were entered into in March, 1956, and closed out in March, 1957. The net out-of-pocket cost to Lewis on the second transaction was $7,772.93. (Pet. 37a.)

A somewhat different transaction was entered into in May, 1957. Lewis instructed Livingstone to sell short for his account $3,000,000 United States Treasury 2¾% bonds due September 15, 1961, and to sell to him $3,000,000 United States Treasury 1½% notes

[1] CF&L was a Massachusetts corporation. It received substantially all its business from Livingstone and paid him for his services. (Pet. 35a; R. 140-141.)

due October 1, 1961. Livingstone arranged for the sale of the 2¾% bonds for Lewis to one dealer and the simultaneous purchase of identical bonds from another dealer for the account of an entity controlled by Livingstone, and he made delivery and settlement arrangements with the dealers. Lewis acknowledged receipt of the bonds purchased and simultaneously sold short. Livingstone also purportedly sold to Lewis the $3,000,000 Treasury 1½% notes for $2,753,299.18, including interest. Lewis agreed to deposit with Livingstone these notes and $168,806.80, representing the excess of proceeds from the short sale of the 2¾% bonds over the price of the 1½% notes. This sum, plus the coupon interest on the 1½% notes, was to be used to reimburse Livingstone for coupon interest due Livingstone on the 2¾% bonds Lewis had allegedly borrowed to cover his short sale. Lewis also paid Livingstone $33,750 as a premium for the alleged loan of the 2¾% bonds. Livingstone advised Lewis that, in addition to the premium, in connection with borrowing the 2¾% bonds he had been charged an expense of $29,144.02 and had been charged a coupon expense of $82,500 in each of the years 1958 and 1959. (Pet. 18a–26a, 38a–39a; R. 147–150, 171–177.)

The Commissioner disallowed both the deductions claimed by Lewis for the cost of borrowing Treasury bonds and the interest deductions claimed in the earlier transaction. The Tax Court sustained the Commissioner and also held that the out-of-pocket expenses or losses actually incurred in these transactions were not deductible. (Pet. 39a.) The court of appeals affirmed.

ARGUMENT

Like *Knetsch* v. *United States*, 364 U.S. 361, this case involves a scheme designed to create for high-bracket taxpayers large "interest" deductions, far in excess of any actual cash investment. It is undisputed that here, as in other cases involving similar plans, the purported purchase of securities was a sham, that no real "indebtedness" had been created under the arrangement, and that the taxpayers' purported "interest" payments were not deductible under Section 163(a) of the Internal Revenue Code of 1954.[2] In the present case the taxpayers contend that certain out-of-pocket losses they incurred in their quest for interest deductions may be deducted in full either under Section 165(c)(2) or, alternatively, as capital losses under Section 1234 of the 1954 Code, *supra*, pp.

[2] See also *Goodstein* v. *Commissioner*, 267 F. 2d 127 (C.A. 1st); *Bornstein* v. *Commissioner* (C.A. 1st), decided June 23, 1964; *Lynch* v. *Commissioner*, 273 F. 2d 867 (C.A. 2d); *Becker* v. *Commissioner*, 277 F. 2d 146 (C.A. 2d); *Bridges* v. *Commissioner*, 325 F. 2d 180 (C.A. 4th); *Nichols* v. *Commissioner*, 314 F. 2d 337 (C.A. 5th); *Salley* v. *Commissioner*, 319 F. 2d 847 (C.A. 5th); *Gheen* v. *Commissioner* (C.A. 6th), decided May 8, 1964 (13 A.F.T.R. 2d 1383); *Rubin* v. *United States*, 304 F. 2d 766 (C.A. 7th); *Dooley* v. *Commissioner* (C.A. 7th), decided June 5, 1964 (13 A.F.T.R. 2d 1657); *Kaye* v. *Commissioner*, 287 F. 2d 40 (C.A. 9th); *MacRae* v. *Commissioner*, 294 F. 2d 56 (C.A. 9th), certiorari denied, 368 U.S. 955; *Williams* v. *Commissioner*, 323 F. 2d 656 (C.A. 9th); *Broome* v. *United States*, 170 F. Supp. 613 (Ct. Cl.). Cf. *Weller* v. *Commissioner*, 270 F. 2d 294 (C.A. 3d), certiorari denied, 364 U.S. 908; *Diggs* v. *Commissioner*, 281 F. 2d 326 (C.A. 2d), certiorari denied, 364 U.S. 908; *Carpenter* v. *Commissioner*, 322 F. 2d 733 (C.A. 3d), certiorari denied, 375 U.S. 992; *Gerstell* v. *Commissioner*, decided July 30, 1962 (P-H Memo T.C., par. 62,181), affirmed on opinion of Tax Court, 319 F. 2d 131 (C.A. 3d), certiorari denied, 375 U.S. 941.

2–3. The decisions below are that neither section is applicable and therefore taxpayers are entitled to no deduction for out-of-pocket losses from their tax avoidance venture. These decisions are correct. The issue has no significance in terms of the planning of future transactions, and its administrative significance is correspondingly limited, since the *Knetsch* decision and opinions following it have eliminated the possibility of tax avoidance by similar schemes.

Taxpayers contend (Pet. 9–12) that their out-of-pocket losses from this transaction designed merely to secure a tax deduction are deductible under Section 165(c)(2) as "losses incurred in any transaction entered into for profit." They concede (Pet. 9) that the transaction in issue was not entered into for any prospect of profit before taxes. In effect the taxpayers are contending, at least inferentially, that the Internal Revenue Code rewards or at least subsidizes taxpayers for unsuccessfully attempting to avoid its provisions. But a transaction entered into merely to avoid taxes (as by creating a fictitious deduction in this case) simply is not a transaction entered into for profit.[3] Taxpayers' argument that their motive in entering into the transaction was to produce an *after-tax* profit is inapposite except to the extent it consti-

[3] Taxpayers' contention is inconsistent with the basic principle of *Gregory* v. *Helvering*, 293 U.S. 465. See *Commissioner* v. *Transport Trad. & Term. Corp.*, 176 F. 2d 570, 572 (C.A. 2d), certiorari denied, 338 U.S. 955, to the effect that the *Gregory* case—

"means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation."

tutes a concession that the transaction was not for profit within the meaning of the statute. Additionally, the taxpayers did not have "losses" within the meaning of Section 165(c)(2). They did put more into the transaction than they took out and therefore were out-of-pocket. But they made the expenditures with the understanding that the cash payment for Livingstone to set up his plan for them would be greater than the cash to be returned to them. A "loss" normally has the connotation of an involuntary result, as distinguished from the voluntary arrangement involved here. In terms of the basic transaction underlying this case, there is no reason for considering the concept of a deductible loss to include the fee for providing the façade by which nothing of substance was expected to be realized beyond a tax deduction. See *Knetsch* v. *United States,* 364 U.S. 361, 366.

In support of their alternative contention that the out-of-pocket costs should be treated as long-term capital losses under Section 1234, taxpayers rely upon *Becker* v. *Commissioner,* 277 F. 2d 146 (C.A. 2d), and *MacRae* v. *Commissioner,* 294 F. 2d 56 (C.A. 9th), certiorari denied, 368 U.S. 955. Although the option apparently considered in those cases, as here, was the choice whether to terminate the transaction at any time and halt the running of the interest, the fact is that a loss on such an option is not deductible under Section 1234 because the statute applies only to "a privilege or option to buy or sell property." See also, Treasury Regulations on Income Tax (1954

Code), Section 1.1234–1 (a) and (c).[4] In light of the courts' uniform rejection of Livingstone-type transactions as schemes for the manufacture of tax deductions, we submit that any conflict on the option issue does not now require resolution by this Court.

With respect to the May, 1957, transaction, taxpayers claimed deductions for premiums paid for borrowing bonds and yearly expenses incurred to maintain their short position. The facts summarized above (pp. 3–5) show that there was no bona fide borrowing of securities and therefore no expense of borrowing. There was no interest to be covered on securities sold short, because, instead of a legitimate short sale, there were only paper entries to which Livingstone attempted to impart an appearance of reality by executing a wash sale of bonds through the brokerage houses of Salomon Brothers and C. F. Childs. The case is not materially different from the other cases in this series (see footnote 2, *supra*, p. 6). There was no real expense of borrowing because in fact nothing was borrowed. Taxpayers' contention (Pet. 13–15) that they had no reason to believe that the transactions were shams is immaterial. *Knetsch* v. *United States*, 364 U.S. 361, 365. Nothing suggests a different result here than in the many closely analogous cases involving sham purchases of securities

[4] Taxpayers also cite *Lynch* v. *Commissioner*, 273 F. 2d 867 (C.A. 2d), and *Goodstein* v. *Commissioner*, 267 F. 2d 127 (C.A. 1st), in connection with their argument for a capital loss with respect to the out-of-pocket expenditures. (Pet. 12–13.) The dicta in these opinions do not suggest any statutory support for taxpayers' option argument.

for the purpose of supporting a plan to obtain tax deductions for purported interest payments.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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